

# LargeCap Strategy

## Q3 2009 INVESTMENT UPDATE



### Market Overview

#### US Equities

The third quarter of 2009 saw a continuation of the “low-quality” rally which began on March 10th, albeit in slightly less extreme fashion. As the dollar weakens on the back of “quantitative easing” (i.e., a ramped-up printing press) and massive projected budget deficits, everything priced in greenbacks is reflating. Count stocks among the beneficiaries.

As discussed last quarter, the increased risk appetite of equity buyers manifests itself in many ways, including a preference for more volatile stocks. To wit, mid-cap stocks outperformed all capitalization groups, the Russell Midcap® 800 Index advancing 20.6%. This group was followed closely by small-cap stocks, the Russell 2000® Index leaping 19.3%. Mega-cap stocks trailed by a sizeable gap, albeit the Russell Top 200® Index recording a hefty 14.4% return for the third quarter.

In the same vein, value stocks outperformed growth stocks by a wide margin across the entire market capitalization spectrum. Value outperformance is typical as the economy shows signs of reaching the end of a recession, as investors alter their mindset toward “a rising tide lifts all boats”. The absolute best performing style group was the **Russell MidCap® Value Index**, which soared 23.6% during the quarter. Next best was the **Russell 2000® Value Index**, which climbed 22.7%. As during the second quarter, the worst performing style index was the **Russell Top 200® Growth Index** (still up 12.7%), with the **Russell 2000® Growth Index** next worst (up 16.0% for the quarter).

**Information Technology** stocks continued their consistent 2009 performance, charging ahead by an additional 17.2%, leaving the sector with a 46.1% gain year-to-date. The best quarterly performance was again in the **Financial** sector (+24.9%), which continues its remarkable rebound from a horrendous 12 months. The stampede from fear to greed over the past 6 months has resulted in lagging performance for the **Telecom** and **Utilities** sectors, though they managed to carve out 6.6% and 6.7% gains, respectively.

### Portfolio Review

We were slightly behind the S&P 500 during the third quarter, and there were several portfolio exposures which helped active performance. Among these were a slight overweight to Health Care stocks, varying exposure to the Transportation sector, and a portfolio tilt against stocks with strong intermediate-term price momentum. New positions which held their own during the quarter include utilities concern **Constellation Energy Group** (CEG), computer hardware maker **Dell** (DELL), and visual technology developer **FLIR Systems** (FLIR). Constellation Energy has topped the S&P 500 by 2.7% since being added to the portfolio on July 14; DELL and FLIR have topped the index by 1.3% and 0.9%, respectively, since purchase.

As you might presume in a market which is screaming higher, the portfolio’s exposure to lower-beta stocks impaired active performance, as did underweighting “value” stocks (where the line between value and “junk” is in this rally, no one is clear). Several new positions in the portfolio did not perform to our expectation.

### Investment Team

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### Firm Overview

- A pioneer in advanced quantitative investment strategies
- Founded in 1996
- Principals own meaningful equity stake
- Manages the following strategies for clients in the US and Europe:
  - MaxCap
  - MaxCap Value
  - LargeCap
  - Sustainable Responsible LargeCap
  - AllCap
  - TaxManaged AllCap
  - TaxManaged LargeCap
  - SMidCap

We purchased database software maker **Oracle** (ORCL) in mid-July, and the position has underperformed the S&P 500 by 15.7%. In September, we purchased stakes in regional and national banks, via **Fifth Third Bancorp** (FITB) and **Bank of America** (BAC). These positions trail the benchmark by 6.2% and 2.6%, respectively, since purchase.

## Portfolio Changes

We increased the portfolio's exposure to the Technology sector by 4.0% during the third quarter, initiating the aforementioned positions in **Dell** (DELL), **FLIR Systems** (FLIR), **Oracle** (ORCL), and **Microchip Technology** (MCHP). The portfolio has a neutral weight to Technology relative to the S&P 500's. We also added to our holdings in the Utilities sector. Here, we opened positions in **American Electric Power** (AEP), **Constellation Energy** (CEG), and **Exelon** (EXC). We are slightly underweight the Utilities sector.

We trimmed the portfolio's exposure to the Health Care sector by 2.4% during the past quarter. Here, we sold positions in biotech companies **Celgene** (CELG), **Amgen** (AMGN), and **Biogen Idec** (BIIB). We also reduced our exposure to the Financial sector by liquidating several smaller holdings, including **NYSE Euronext** (NYX), and **Vornado Realty** (VNO).

### Top Active Weights - 09/30/09

Top Five Overweights vs. S&P 500	Portfolio
Freeport-McMoRan Copper & Gold	2.80%
eBay	2.51
Harris Corporation	2.31
Wells Fargo	2.26
Intuit	2.19
Top Five Underweights vs. S&P 500	Portfolio
General Electric	-1.89%
Apple	-1.77
AT&T	-1.72
Cisco Systems	-1.41
Google	-1.28

## Recent Transactions

As a reminder, our quantitative portfolio management process places emphasis on the construction of an entire portfolio, seeking to maintain a risk profile very similar to that of our S&P 500 benchmark. Stocks are included

in the portfolio not only for their expected return, but also for their contribution to the portfolio's risk profile.

## Purchases

**Dell** (DELL) engages in the design, development, manufacture, marketing, sale, and support of computer systems and services worldwide. Our models rated Dell highly based in part on elements of its trading pattern and risk characteristics, including its larger market cap and strong short-term trading pattern relative to its poor intermediate-term pattern.

	Portfolio Weight	S&P 500 Weight
Consumer Discretionary	5.82%	5.31%
Consumer Staples	12.42	10.40
Energy	12.42	10.72
Financials	18.20	16.14
Health Care	12.63	12.74
Industrials	4.37	7.27
Materials	7.11	5.14
Retail	6.69	5.42
Services	1.28	5.70
Technology	17.11	17.52
Utilities	1.95	3.64

**Exelon** (EXC) engages in the generation, transmission, distribution, and sale of electricity to residential, commercial, industrial, and wholesale customers in northern Illinois. The company also purchases and sells electricity and natural gas on retail basis to customers in southeastern Pennsylvania. It generates electricity through nuclear, fossil, and hydroelectric generation facilities. The drivers of Exelon's strong forecast were very similar to Dell's: larger market capitalization combined with a strong and improving trading pattern.

**Reynolds American** (RAI) manufactures cigarettes and other tobacco products in the United States. In addition, Reynolds American offers loose leaf chewing tobacco, dry snuff, and plug and twist tobacco products. The company operates in three segments: Investment Cast Products, Forged Products, and Fastener Products. RAI's attractive rating had more to do with fundamentals: excellent return on capital, strong pattern in earnings estimate revisions, and solid earnings quality.

## Sells

**Amgen (AMGN)** engages in the discovery, development, manufacture, and marketing of human therapeutics based on advances in cellular and molecular biology. The company markets human therapeutic products primarily in the areas of supportive cancer care, nephrology, and inflammation. AMGN performed much better than the S&P 500 benchmark during our holding period, topping the index by 19.8%. Despite solid return on capital figures, Amgen's intermediate-term price momentum made the stock score poorly. We exited the position on July 28th.

**DR Horton (DHI)** operates as a homebuilding company in the United States. The company's homebuilding business engages in the acquisition and development of land for residential purposes, and construction and sale of residential homes. It builds traditional single-family detached homes and attached homes, such as town homes, duplexes, triplexes, and condominiums. Poor earnings quality and return on capital figures led our models to an unattractive rating for DHI. We exited the position on July 28th, and the stock beat the S&P 500 Index by 11.9% during the holding period.

**Visa (V)** operates retail electronic payments network worldwide. It facilitates commerce through the transfer of value and information among financial institutions, merchants, consumers, businesses, and government entities. This was another July 28th sale, and Visa

trailed the S&P 500 Index by 6.7% during our holding period. Visa never did perform to our expectations at the time of purchase, and a continued decline in price led to the eventual sale.

## Market Outlook

Let's take a moment to stand on the shoulders of giants and look ahead. Firstly, in an article penned for the Wall Street Journal, James Grant (editor of Grant's Interest Rate Observer) notes, "the deeper the slump, the zippier the recovery", and that there are no exceptions to this rule. Further, he cites English economist Arthur C. Pigou's observation that "the error of optimism dies in the crisis, but in dying gives birth to an error of pessimism. This new error is born not an infant, but a giant."

I often conclude our quarterly commentary with a reminder of the tenets of our investment methodology, including discipline, objectivity, and adaptability. Grant himself invokes the words of an investing giant (Henry Singleton, longtime CEO of Teledyne, whom Warren Buffet described as the best allocator of capital):

"I know a lot of people have very strong and definite plans that they've worked out on all kinds of things, but we're subject to a tremendous number of outside influences and the vast majority of them cannot be predicted. So my idea is to stay flexible." Count on us to emulate this.

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Investors cannot invest directly in an index. These indexes are not managed or sold by Advanced Investment Partners.

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